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April 14, 1978 **LETTER 727**

Mar. 31, DJIA 757.36; PTI 726; A-D Ratio –20.61
April 7, DJIA 769.58; PTI 744; A-D. Ratio –20.16

THE MARKET: We're at a fascinating juncture. The excitement in the secondary stocks has infected Wall Street and the advisory services to the point where I feel emotions are taking over. Crystal-ball predictions are running rampant. "We've seen the bottom." "The bottom will come with one more drop on the Dow, maybe to 730." "The bottom will come in May." "The market's going to run away on the upside."

I've cautioned many times that it is far easier (on the psyche and the pocketbook) to **identify** a bottom than it is to predict one. In Letter 723 I ended with a discussion of the importance of the Dow 744 level under the Fibonacci studies. I stated, "The Dow 744 Fibonacci level could be significant enough to set of an 'impressive rally,' but I believe such a rally would represent a trap for the bulls." I then went on to say that the downside non-confirmation by the Transports and the A-D Ratio "would provide fuel for the bulls if a rally takes off from here." Nevertheless, I added that I did not want my subscribers to play the rally, since my data indicated that a major bottom was not at hand.

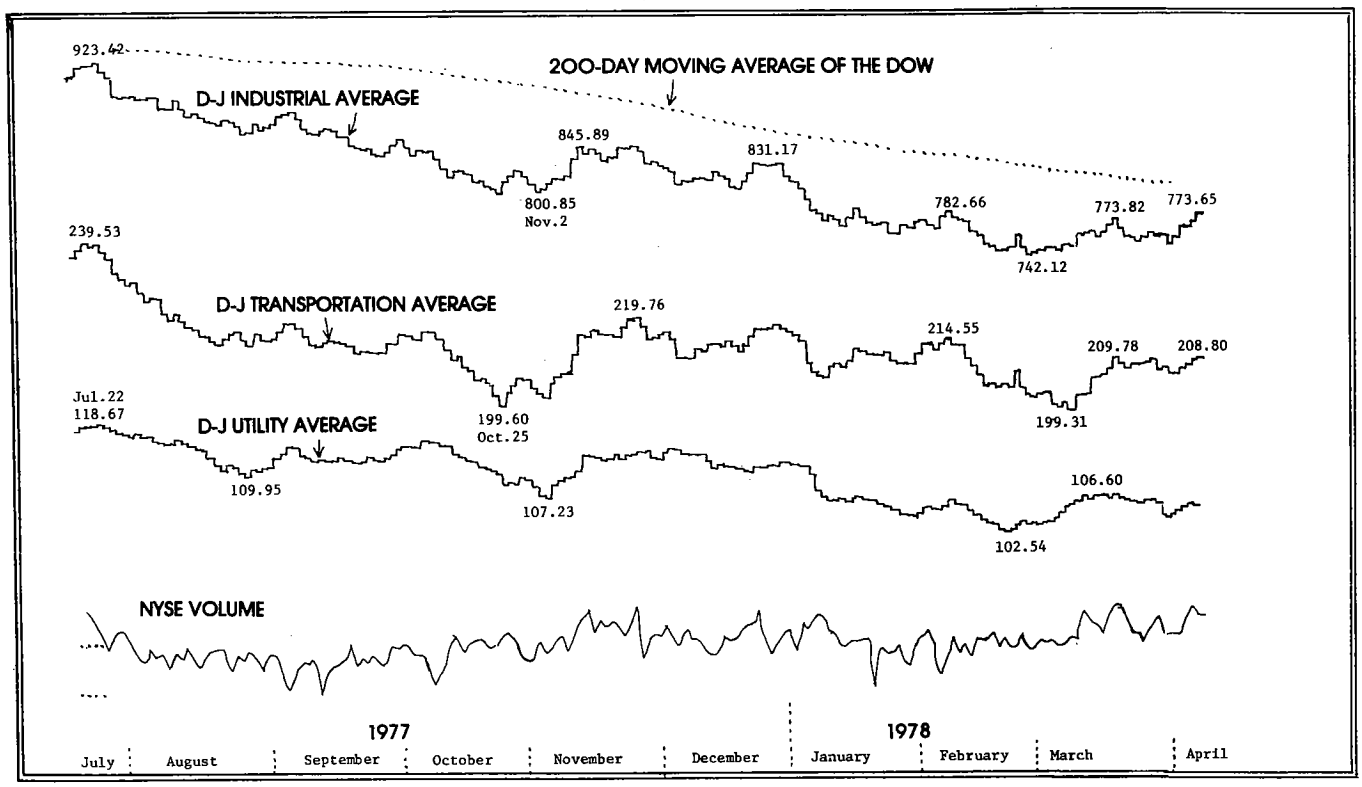
What happened? The Dow hit an actual 742.12 low on February 28. Since then it has pushed to a March 20 high of 773.82, a gain of 4.2%. My indicators (never over-sold in 1978) turned over-bought on March 17, one trading day before the 773.82 peak. At present, the indicators I use are still very over-bought. But I am aware that the market can push an over-bought to a flagrant over-bought. I am also aware that "the market can do anything" (particularly over the short term).

My own thinking is crystallizing more and more along the following lines. Based on long-term moving averages (see Letter 724 and this Letter), based on the towering US debt situation, based on the patterns of the leading averages and composites, based on the NYSE margin debt situation, I believe the market is forming a long-term top of major proportions.

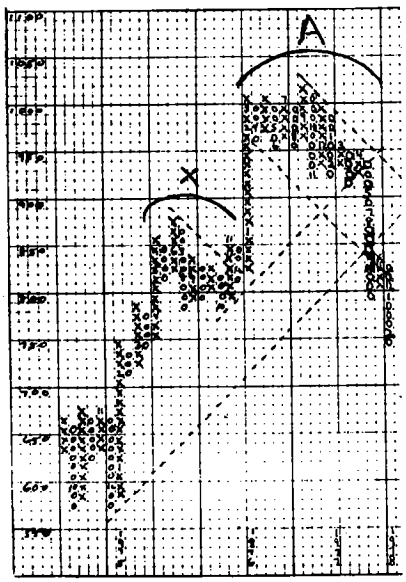
As I see it, the Dow Industrials were under heavy distribution during late-1976 and 1977. I have illustrated this distribution phenomenon on the accompanying point & figure chart (page 2), and I have marked the actual distributive area with an arc and the letter "A" (chart courtesy of *Chartcraft*, Larchmont, NY). So massive is the supply of Dow stocks that any concerted advance by the Dow runs into selling, particularly in the area of Dow 780 and above (the 780 to 850 supply area is identified on the chart with the Letter "X").

I believe the "rest of the market" is also under distribution, and I include a P&F chart of the S&P 500 Composite, an average which is weighted for each stock's capitalization. The 500 provides a good measure of the entire market. Note that the area marked "B" on the chart appears to be a distributive area with massive supply (i.e., stock for sale) in the 90 and above area.

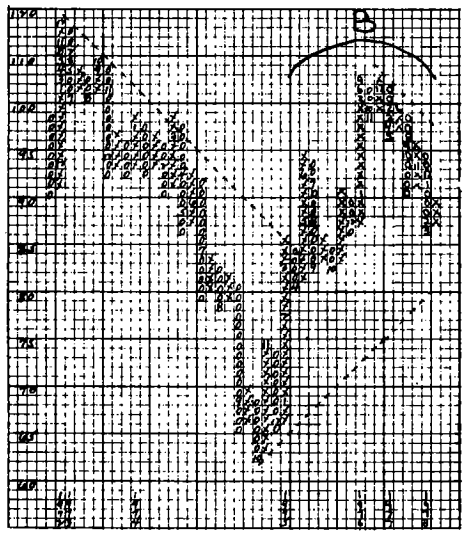
An even more comprehensive picture of the NYSE is shown in the chart of the NYSE Composite Index. This Index covers all (over 1500) common stocks on the NYSE, and it shows all price changes daily (this composite is weighted for the number of shares outstanding in each issue). The picture here is of a huge head-and-shoulder top with massive supply at the 53 and above



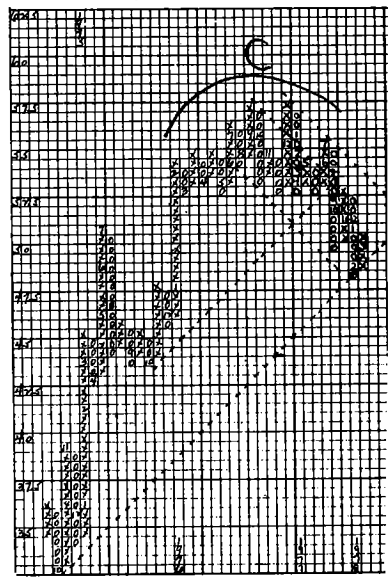
DOW-JONES INDUSTRIAL AVERAGE (10 x 30)



STANDARD & POOR'S "500" - Closing Prices



NYSE COMPOSITE INDEX - Closing Prices

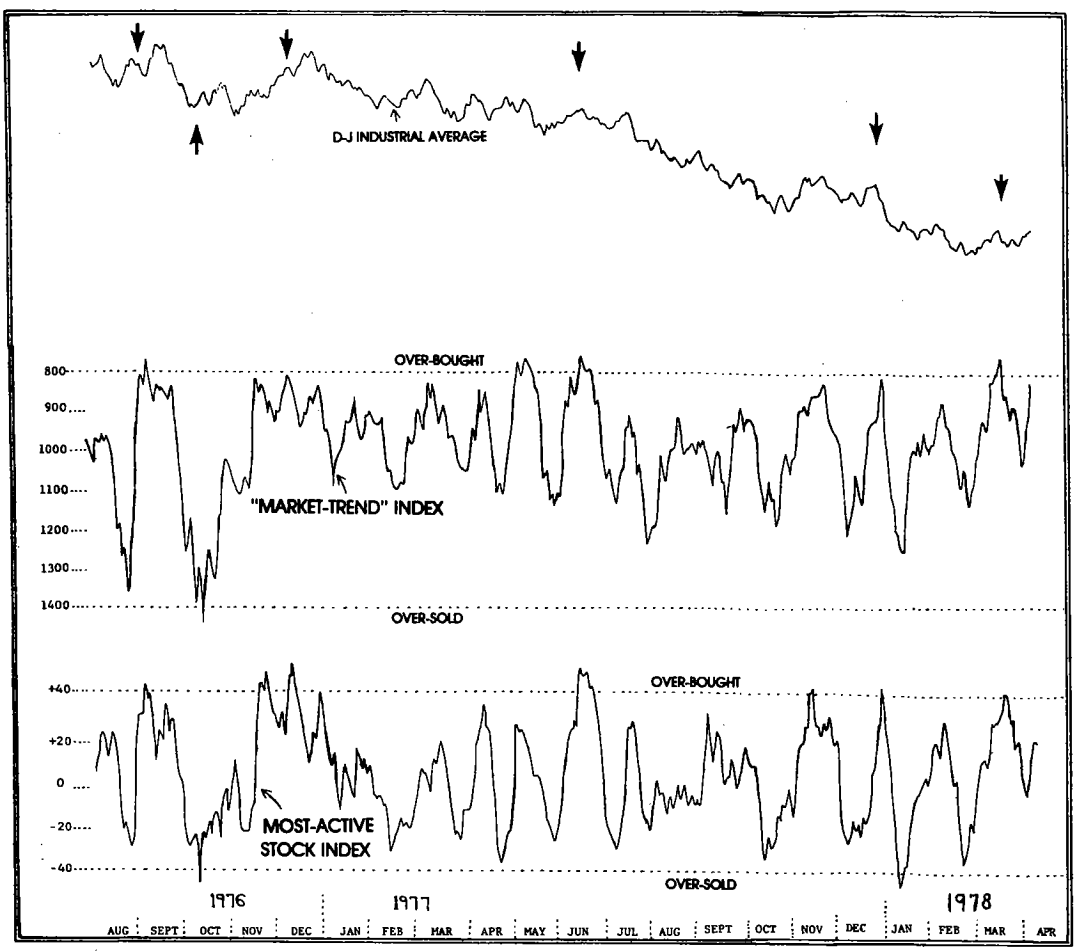


area. The NYSE Composite has made a number of attempts to push above 52.5, but each time an avalanche of "stocks for sale" sends this Index to lower levels again.

As I see it, with massive distribution having taken place in the Dow stocks and many sectors of the NYSE, we are now seeing excited rallies in the remainder of the markets, the AMEX, the NASDAQ, and many smaller-capitalized NYSE issues. I have said before that I think we will be seeing "big advances" and mini-bull markets, all within the framework of a secular decline in the major trend of equities.

Tactically, what this means is that we must wait for the most advantageous periods in which to enter the market. We will not be buying for a great bull market such as 1949-66; rather we will be buying for a six-month to perhaps one or two-year bull market. Which is fine, but first we have to identify the bottom. Unfortunately, I haven't been able to do that yet.

SHORT-TERM: With the Industrial and Transportation Averages in the vicinity of their preceding peaks, my two indices (having failed to work off their over-bought status), are pushing back into the over-bought zone again (see chart below). Any time these indices push into the high area (as they are now doing), the market becomes a poor risk-reward proposition. This is doubly true since the rally, as you can see on the chart, did not begin from an over-sold base (see late notes on page 6).



MOVING AVERAGES: In Letter 724 I discussed some of my work with **very long term** moving averages of the Dow. The moving average concept is a simple one, so simple that I am not sure that most people really understand it.

As I explained in Letter 724, the long-term moving averages move slowly–very slowly. For instance, let's study the accompanying page 3 chart, which shows a picture that I don't think you will see anywhere else. Here we see the 55-month (or 4.58 year) moving average of the Dow (dotted line). We also see the 13-month (a little over one-year) moving average of the Dow (solid line).

Now let's study the action of those two MA's. From the inception of the great bull market

(beginning in 1949) to as recently as 1969, the 55-month MA trended higher. There was never a period of decline. The question might be asked–"What was this extraordinary and persistent rise telling us?" I believe it was saying that large investment interests (the kind that buy the blue-chip Dow issues) were willing to pay HIGHER AND HIGHER AVERAGE PRICES for the big Dow-type stocks, the "back-bone of the economy" stocks. Thus the super-primary trend (the secular trend) of the Dow remained strongly bullish.

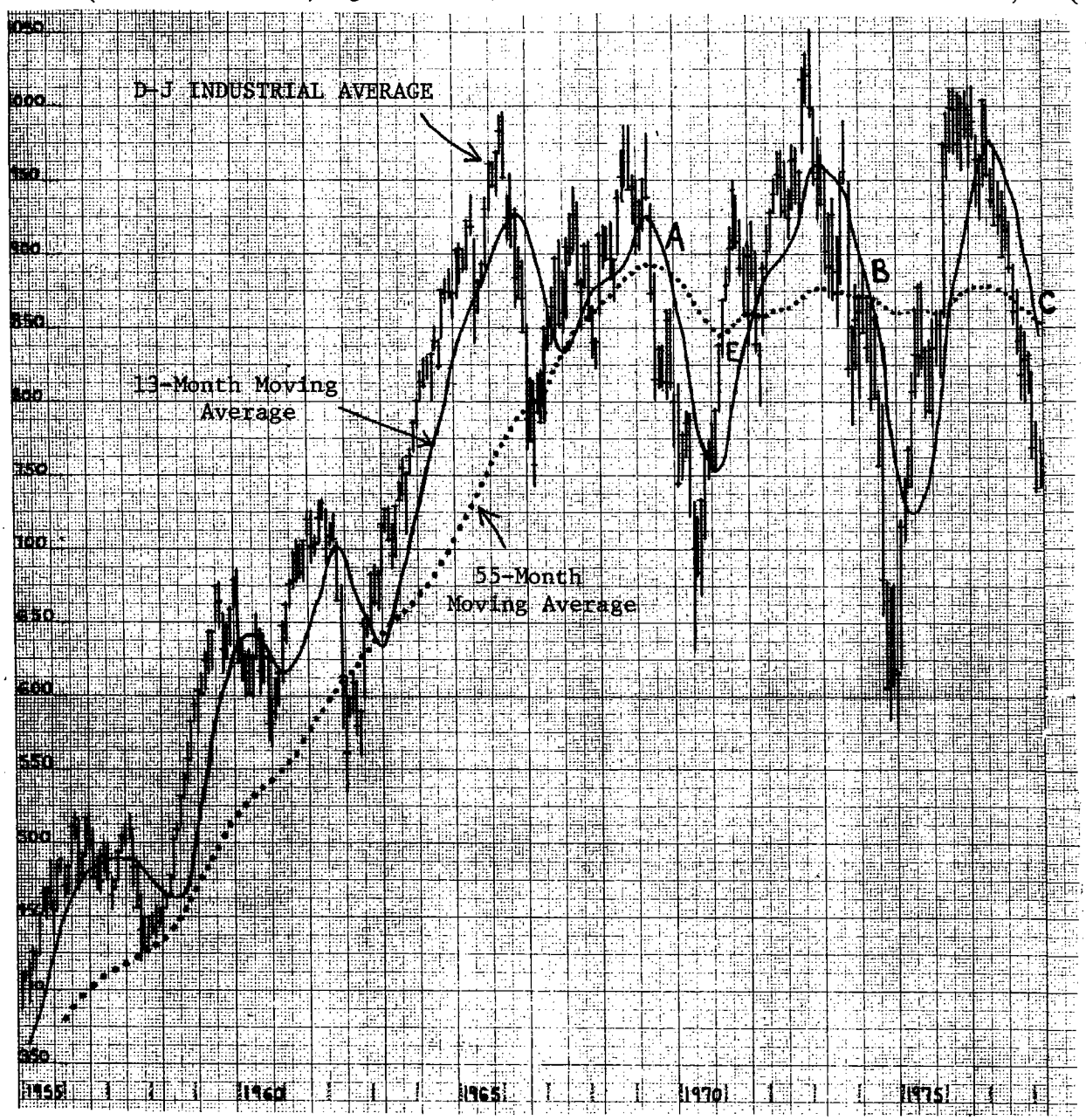
Meanwhile, the shorter 13-month MA was rather closely following the outline of the Dow itself, as you can see on the chart. But at no time up to 1969 did the 13-month MA decisively break below the 55-month MA. This remarkable performance ended in July, 1969 (A on chart) when the 13-month MA plunged 132 points below the 55-month MA. Here for the first time we see the 55-month MA turning down. It is interesting to see that the 55-month MA has not been back to its 1969 high of 893 since.

Note that following the penetration of the 13-month MA below the 55-month MA at point A, the Dow itself smashed to a low of 631.16 (this occurred in 1970). Again in 1974 (B on chart) the 13-month MA broke below the 55-month MA. This action was followed by the Dow crash to the late-1974 low of 577.60.

The 55-month MA turned up in January, 1975 and advanced to a high of 878 in 1977. From this latest peak the 55-month MA turned down again. By the end of March, 1977, the 55-month MA was down to 854 and in an established declining trend as you can see on the chart. At the same time (end of March) the 13 month MA (now at 845) broke below the declining 55-month MA, its third such penetration on the chart.Whether this third penetration is going to set off extraordinary selling pressure (as during 1969 and 1974) remains to be seen.

A few further comments are in order here. I always consider a penetration of a longer-term MA by a shorter-term MA to be particularly significant when the longer-term MA is in a **declining trend**. The reason is that both MA's are then showing ebbing momentum, and the downward penetration has much more force.

I believe it is significant that the 55-month MA is (1) now in a definite downtrend for the first time, and (2) currently within 8 points of its 11-year low of 846 recorded in December, 1970. With the 55-month MA now dropping at the rate of 2 to 4 points a month, this MA will be below its 1970 low (E) by about August of this year. Thus, as I see it, by Fall we will have the 13-month MA below the 55-month MA and the 55-month MA will be at its lowest level since the 1960's. Th confluence shoul have the effect c putting a massive technical "roof" over the Dow at about the 850 level.



It seems to me in studying the chart that we are not seeing a cyclical decline in the Dow (i.e., a situation based on shorter business cycles) but a secular decline based on very long term factors. To put it another way, what

I think we are seeing is NOT a market that is simply discounting a business recession or an easily solved list of temporary problems. We are seeing a market that is facing problems like 35 years of inflation, an almost unmanageable debt situation in the nation, a market that cannot see an end to the dollar problems, a market that is dealing with ever-higher levels of interest rates.

I don't have space in this Letter to show it, but I keep another chart with an even longer-term MA, a 156-month (13-year) MA of the Dow. This "super long" MA turned down in December, 1977 at a value of 874. Significantly, this is the first decisive decline in the 156-month MA in over two decades. The 156-month MA is now declining at the rate of 2 to 4 points per month, and it is obvious to me that we are seeing something extremely important in this action.

Question: Russell, I get the picture. What you are saying is that the long-term MA's are declining for the first time in many years (even decades).But what do we do with this information? How do we operate in this environment?

Answer: As I see it, we are moving into a period in which the very long term or secular trend of the markets and the economy will be down. I think that is the meaning of the persistent and almost grisly slide in the "backbone of the market" stocks, as represented by the D-J Industrial Average.

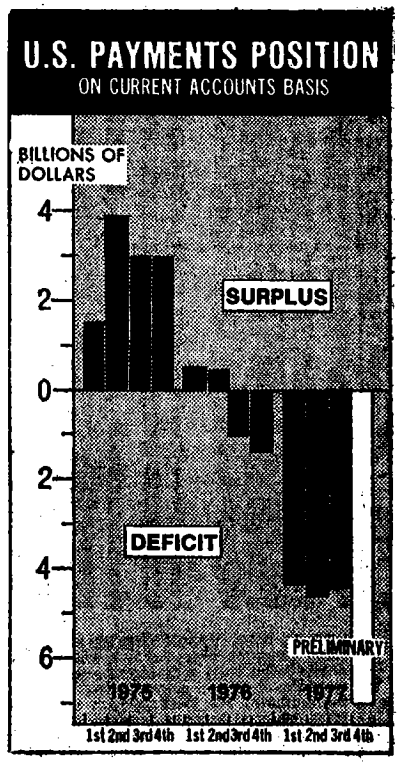
This situation will present great difficulties, but not insurmountable ones. Without the secular bull trend behind us (as it was all during the 1950's, 1960's) and based on the 156-month MA during much of the 1970's, we will have to exercise a good deal more skill than before. I think over coming years we are going to see mini-bull markets instead of big bull markets, mini-bull markets which will appear within the secular bear market.

I think we will see investors and speculators try in every way to "beat" the secular or overriding bear market, and we are seeing some of those efforts now. We are seeing it in the move into collectibles and stores-of-value, we are seeing it in the speculation on the AMEX and NASDAQ and in the "takeover" stocks. How successful all this will be remains to be seen.

But there will be major over-sold areas, and there will be mini bull markets.And it will be in these areas that I personally believe the best and safest profits are to be found. As readers know, I am waiting for that elusive over-sold bottom to appear, and I don't know whether it's coming in a month, in three months or in mid-1979. But come it will–I'll guarantee it.

In the meantime, patience and an understanding of the overall situation will be crucial for every investor. For with the secular trend down (as portrayed by my long-term MA's), we are all put in the position of being survivors. That means that the market odds are going to be very difficult, the odds on retaining our purchasing power are going to be adverse. We will be fighting a holding action as far as our purchasing power is concerned. And the strategy I advocate is moving into the periodic mini bull markets, garnering profits in them. And in so doing we will be making up for any losses sustained during the inflation, deflation or attrition periods that lie ahead.

NEXT MAILING: April 26th



CHANGE: This chart (from the L. A. Times, March 23) shows the latest US payments position on a current accounts basis. The current accounts include value of goods and services between the US and foreign nations, investment income and Government grants and pensions abroad; in other words, the "whole works." To put it bluntly, the 1977 current accounts deficit was $20.2 billion compared with a deficit of $1.4 billion in 1976. The previous worst current accounts deficit was the $9.9 billion of 1972.

There's no way, no way in creation, that the US can continue on the current path of wild spending, sky-rocketing budget deficits, careening trade deficits, and mindless expansion of Government agencies. It must and will end as surely as night follows day, and I'll stake whatever reputation I have on it–it will end.

As a matter of fact, I wonder if we're not seeing the beginning of the end of the super-spending process now. At this point, half of the Federal budget expenses go to completely non-productive uses. By that I mean that 50% of all Federal expenses go to the HEW, HUD, welfare, handouts, interest on the national debt. What is really happening is that the US is trying to hold itself up ("spend itself up") by its own suspenders. And the suspenders are getting a bit frayed.

Nevertheless, the winds of change are beginning to blow. Suddenly Congress (upon hearing the agonized shouts of voters) is panicking on the Social Security payment boosts, and new "lower boosts" are in the cards. The national health insurance concept is fading. The Consumer Protection Agency has been killed by Congress. California, with its Jarvis Amendment, may be setting off a tax revolt that will be heard from one end of the nation to the other. Consumerism as a rallying force (along with Nader) is fading away. And the entire nation is smouldering under the onus of a system of red tape, taxes, and mindless paperwork, which, to my mind, is about to receive its first head-on confrontation.

I believe we are only seeing the beginning, the tip of the iceburg as far as the "revolt of the American public" is concerned. But it's happening, as sure as the unions themselves are weakening, as sure as the American middle class is raising its bloodied fists, and as sure as Congressmen (with their ears to their constituents) are slowly but surely getting the new message. What is the message, you ask. It can be expressed in four words. "We've about had it."

We've come to the point where the entire world is up in arms against the sliding dollar. Switzerland has erected barriers, Germany has said "No" to our demands that they inflate "to help the dollar." Japan has given token aid to the dollar while

continuing its export blitz. Gold has moved to within a dozen points of its all time high, the dollar has collapsed against the strong currencies, and even against the trade-weighted basket of 14 currencies, the dollar is at a seven year low.

The remedies for all this are harsh, indeed. But the remedy for any terminal disease is harsh. And the longer one avoids the doctor, the more drastic the ultimate remedy. Among the things which must be done are (1) US oil and gas prices must be decontrolled, so that the forces of supply and demand are allowed to work. (2) Washington must begin, and I say *begin*, to face reality. Regardless of the pain involved, the US budgets MUST be balanced. (3) The welfare programs must be cut to the very bone, the huge Federal and state give-aways must end, the Federal agencies must be trimmed back drastically. (4) A new philosophy and spirit of thrift must sweep over the nation, a spirit akin to the old Puritan work ethic or the current Japanese work ethic. Savings and production must be encouraged, while deficits must be discouraged. (5) The dollar must have some form of gold backing so that it becomes a respectable currency again.

In the absence of this kind of drastic program, the markets themselves are likely to "do it all for us." By that I mean that one way or the other, we will ultimately see a wave of liquidation and deflation which will serve to knock over the debt structure of the US (and perhaps the world). If this occurs, then the nation will have far less control over its destiny than it would if the squeeze had come voluntarily. But either way I believe the great squeeze is coming. "No tree grows to the sky," and even while the US debt tree is growing, its roots are rotting away. Wall Street knows this, and the Street has been protecting itself against this eventuality ever since 1966 (or if you prefer, since 1973 or 1976).

Sadly enough, I see little or no sign that our President is working on any of the solutions for the problems that the market is now discounting. Worse, I don't believe Mr. Carter or his cabinet is even aware of the questions.Every meteorologist knows that before lightning strikes, great clouds must form. The clouds are now visible for all to see.

As an aside, I am including two news clips, each indicative of what is happening at this time. The bankruptcy piece (from Dun's magazine) is self-explanatory. The piece on state taxation (top of page) I found utterly disheartening. It points to the insidious move by the states to tax whatever the Federal Government doesn't tax. Does anyone wonder why inflation is now a built-in process?

WASHINGTON (AP) — States took in more than $100 billion in taxes for the first time in the year ending last September, increasing their collections by 13.2 percent, the Commerce Department reports.

The 50 states combined collected $101 billion in fiscal 1977, up from $89.3 billion the year before.

Bankruptcy, which was once shunned as a condition to be avoided at all costs, has become an increasingly commonplace occurrence in American life. Fueled by easy consumer credit, bad corporate decisions and a waning of the Puritan Ethic, there were 250,000 bankruptcies last year in a generally prosperous economy, compared with only 10,000 in 1946. Individuals accounted for 85% of the bankrupts and businesses 15%. More than 9 million creditors filed $43 billion in claims against the bankrupts' assets of only $27 billion.

THE WHOLE THING: I follow the Wilshire Index (figures in *Barron's* each week), because this index settles a lot of arguments. It consists of the *actual dollar value* of 5000 stocks. These 5000 stocks include the entire NYSE, the entire AMEX, and the leading NASDAQ stocks (chart at bottom of page).

The Wilshire hit a high of $916 billion on the week ending December 31, 1976. Since then, it has dropped to a low in March, 1978 of $794 billion. The latest figure is $826 billion. Thus, at this writing the Wilshire is telling us that "the markets" have lost $90 billion during 1977 and 1978 (so far).

I think it is interesting to note the slow but relentless "rolling-over" effect that we see in this ratio-scale chart of the Wilshire. Actually, the pattern is not too different from the long-term moving averages that I have shown on the Dow. It's as if the markets (all of them) under the guise of periodic speculation and frothiness, are slowly but surely drifting off to lower levels.

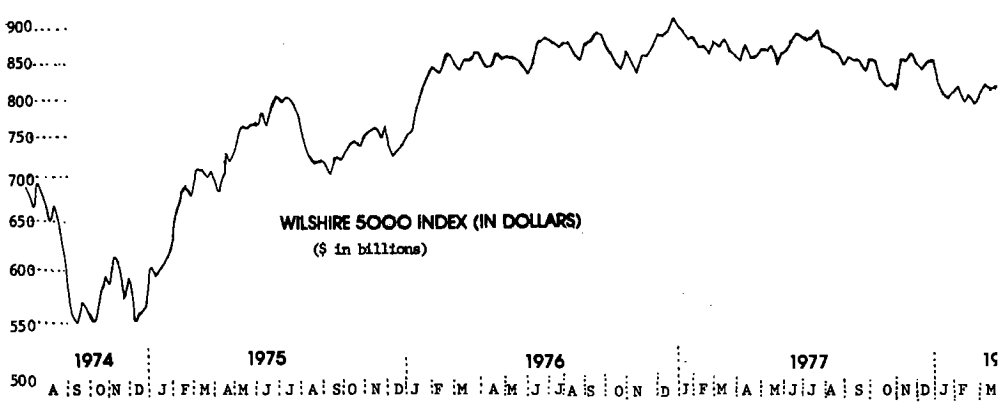
One thought I have regarding this process is that important money and large quantities of it is being attracted increasingly to the safety and the surety of bonds. As I write this the US Treasury 8's of 1996 have dropped to a new low of 96 10/32nds at which price (see chart in the last Letter) they yield a fat 8.34%. That's 8.34% with the full faith and credit of the US Government behind them (and this yield is exempt from state taxes, which makes it even more attractive).

But don't run to buy the Treasury bonds–yet. My guess is that they are on their final leg down–but that they are going lower (with higher yields, of course).

At any rate, consciously or unconsciously, investment money seeks safety, yield and appreciation. It is probable that investment money is now moving out of equities into bonds, and the Wilshire Index could be charting that flow of funds.

GOLD: There are only two reasons to own gold today. The first is the lesser reason, and it is that gold can conceivably be a hedge against inflation. Actually, at this point in time I doubt whether gold will be a better hedge against inflation than say the right commodity, the right collectible, the right art, the right stamps, coins, antiques, etc.

But where gold does become a most interesting item is during periods of economic chaos or during periods of frightening



economic instability. At such times, gold becomes the "asset of last resort," the indisputable reserve asset which can be bought and sold in any quantity at any time.

As I've been pointing out in Letter after Letter (and certainly in this Letter), we live in perilous economic times. There is a lot of margin for error in what our Government is doing today. The markets of the world are swinging wildly as they seek to measure the pluses and minuses of the economic and financial picture. In such an environment, gold becomes our number one insurance.

Rather ironically, two news items from Switzerland enhance the attraction of gold. The first is that the Swiss are proposing removing the gold backing from their franc. While the franc is 61% covered by gold anyway, this proposal nevertheless is an attempt to make the franc less attractive to foreigners. A second proposal by Switzerland's leading political party is to drop some of the secrecy from Swiss bank laws. This too would make Switzerland a less attractive place for international "insurance money." And conversely, it would make ownership of gold more attractive.

On March 11 President Carter made his widely-heralded "anti-inflation" speech. He said absolutely nothing of note, and gold spurted a bit on the total nothingness of Carter's stance. As you can see on my chart below, gold has corrected by breaking below its 4-week moving average. But the metal has held nicely in the vicinity of the longer-term 13 week moving average. It is possible that gold will scare out the last speculators by breaking to a new low in the low 170's, thus tracing out a downward zig-zag on the chart. But I would not bet on this, as I believe there are too many sold-out gold bears waiting for that wipe-out to buy.

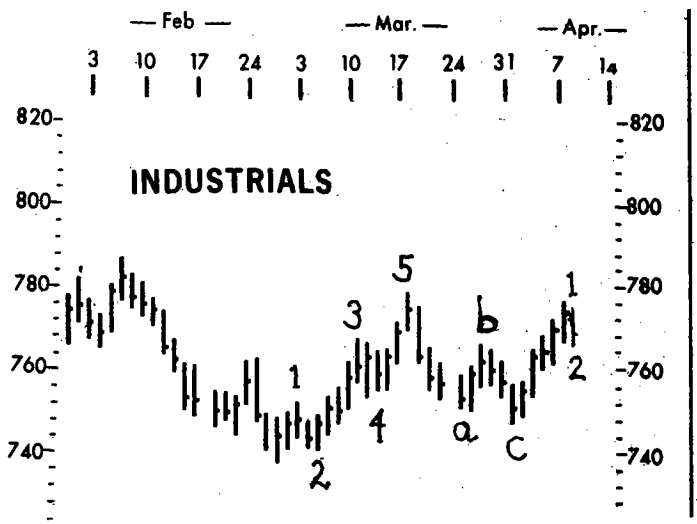
Any move by gold above 184 would provide a bullish signal on my charts, and I would guess that a push above 184 would send gold up for the test at 190 in fast order. Despite what almost everyone is saying, I feel gold is acting well, and I believe gold traders stand more chance of being stopped out than in making money.

The gold rumor mills are pounding again, and the story is that "maybe" the US will sell up to 250,000 ounces of gold. Maybe, maybe, but if US threats and sales and the admonitions of Treasury Secretaries and assorted Administration spokesmen could knock gold down, the yellow metal would be selling at about $3.98 a pound today. The fact is that the primary trend of gold is bullish, and for the long-termer, that's all you have to know.

We know that the longer a primary bull market is held back, talked down, scolded and threatened, the stronger it becomes. Gold was held back from 1934 to 1974 by US law, even while the primary trend of the metal was bullish (we can infer this from black market prices for the metal). But once freed, the gold explosion amazed the world, and the price of gold rose 463% before topping out.

Gold has been correcting since late-1974 or for over three years. My studies indicate that gold means (in due time) to push above its old high closing (London fix) of $197.50. The longer the backing-and-filling and consolidation prior to new highs, the bigger the surge once 197.50 is bettered. Meanwhile, we will have to exercise PATIENCE.

LATE MARKET NOTES: The market, even though it is over-bought, is going to do what it has to do to fulfill its "pattern destiny." The chart from the WSJ shows the daily Dow action from the March lows. I believe we are seeing an Elliott (upward) correction, a typical 5-3-5 pattern. I count 5 little legs up on the chart, a perfect little a-b-c down, and then the start of what should be the final part of this upward correction. At 5 (1 and 3 are probably completed) the Dow should be exhausted. I doubt whether the Dow can get back much above 780-800 since the initial upward corrective wave (1 through 5) was so unimpressive. It's taking a tremendous amount of volume to move this market higher. We'll stand aside.



THIS WEEK'S JOKE: Maybe LBJ started it when he turned out the light in the White House. But the new political image is, "Look like a miser, spend like a maniac." California's Governor Brown has been doing it for years, Carter's affecting it ("I'll carry my own bag"), and now NYC's Mayor Koch is doing it ("see me before you drive a limousine"). Help, I'm drowning in hypocrisy.....